GROWTH, STABILITY AND BALANCE OF PAYMENTS

by

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This paper deals with Sri Lanka's experience of managing the economy in the face of crisis situations and was presented at the Asian Development Bank-Institute of Policy Studies Seminar on **Monetary and Fiscal Policy for Crisis Management**, 11- 13 July 1991, Beruwela, Sri Lanka.

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CONTENTS

1. INTRODUCTION 1

2. ECONOMIC GROWTH 2

3. STABILITY 3

4. BALANCE OF PAYMENTS 6

5. SRI LANKA POLICY ENVIRONMENT 8

6. ECONOMIC GROWTH 11

7. INFLATION 13

8. BALANCE OF PAYMENTS 16

9. CONCLUSIONS 23

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1. INTRODUCTION

This paper follows very closely the theme of the Conference, even though the emphasis will be on longer-term issues. It seeks to explain the role of fiscal and monetary policies in dealing with problems of economic growth and stability in crisis situations. While certain theoretical and conceptual issues will be dealt with at the outset, the main focus will be on the Sri Lankan experience during the years 1978-90. An attempt will also be made to look at perspectives for the future.

It is now well accepted that economic growth is a necessary, though not a sufficient, condition for development. Economic growth must be accompanied by equity in distribution. In the appropriate mix, equity and growth tend to reinforce each other. Therefore, policy instruments which violate this harmonious relationship cannot help to achieve the goals of development.

While economic growth could be viewed as an end in itself, internal and external stability cannot be seen in the same way. They are important only to the extent that they serve a fundamental purpose. Internal economic stability, understood in simple terms as a non-inflationary or low inflationary situation, is important only to the extent to which it promotes the fundamental purpose of development -- that is, economic growth with equity. The position regarding balance of payments is the same.

Fiscal and monetary policies, though important, are not adequate to deal with problems of growth and stability. They have to be supplemented by other measures,

[1] The writer wishes to acknowledge with gratitude the assistance provided by Nimal Siripala and P.Samararatne in compiling statistics. In particular he would like to thank Dr. Howard Nicholas for very extensive and helpful comments on an earlier draft. Responsibility for acts of omission and commission naturally rests with the author. It is also necessary to add that the views expressed in this paper do not necessarily reflect the views of the organisation to which the writer belongs.

particularly institutional changes, to bring about the desired results. Furthermore, to use medical parlance, fiscal and monetary prescriptions must be efficacious and have minimum side-effects.

Developing countries are in a permanent state of crisis. The Gulf war is only one such crisis. In actual fact the Gulf war broke out at a time when there was an emerging crisis of far greater consequence to developing countries, namely, the economic recession in the United States. The economies of developing countries are vulnerable to exogenous shocks generated both domestically and internationally. The extent of the impact of these shocks no doubt depends on the structure of the economy concerned. Countries with a large agricultural sector and uncertain weather patterns are subjected to greater exogenous shocks than others. Similarly, countries with a large external sector, which are structurally weak, such as those highly dependent on primary commodity exports, are more vulnerable to external shocks.

Viewed in this light, Sri Lanka is a country in a permanent state of exogenous shock and crisis. Its dependence on agriculture, particularly on primary commodity exports, the small size of the domestic market and its narrow resource base, expose it not only to the uncertainties of weather but also to the vagaries of the international market. The Gulf crisis is just one of those international incidents which had a significant impact on the Sri Lankan economy. Economic management and policy instruments adopted in Sri Lanka must, therefore, be capable of responding quickly and effectively to economic shocks that may frequently emerge.

This paper will begin by dealing briefly with the nature and role of fiscal and monetary instruments in a developing country like Sri Lanka. Thereafter, it will proceed to analyse the experience of the last 14 years, followed by a brief overview of the policy options for the future.

2. ECONOMIC GROWTH

Economic growth is influenced by a variety of factors. Basically it is a function of investment (savings) and the productivity of investment. Fiscal policy can influence the level and composition of savings and investment in a variety of ways. For instance, taxes can restrict private expenditure - both consumption and investment - and divert resources to the government for its use, including investment. We need not dwell on these well known aspects of fiscal policy. What is relevant here, in view of the significance attached to it in IMF-type stabilisation programmes, is the role of the interest rate in increasing savings.

There is little empirical evidence to suggest that real positive interest rates promote overall savings. Aggregate savings are primarily a function of income and institutional factors. Differential rates of return (including interest rates) are likely to shift individual asset portfolios to areas of activity where such returns are higher. On the other hand, interest rates add to costs of production. Even though they may form only a small proportion of an individual firm's total costs, interest rates add vertically to the working capital costs of an industry. High interest rates therefore have the potential of promoting cost-push inflation. This is a side-effect which cannot be ignored. The largest level of interest rates must be based on an analysis of concrete situations.

3. STABILITY

Should a country aim at zero inflation rates? This is in any case impossible in a small developing country with very strong links with the rest of the world. International inflation rates, or more precisely import prices, are bound to influence domestic prices. The question is, therefore, what is the rate of inflation beyond which development would be in jeopardy ?

The effects of inflation are well known. The following are worth recalling. First, in the absence of strong bargaining power on the side of workers, inflation tends to reduce real wages and redistribute income in favour of profits. Unionised workers are a small fraction of the total wage earning labour force in a developing country and, even

where they belong to unions, their bargaining power would be determined by the political balance of forces.[2]

Second, inflation often has an adverse impact on the balance of payments. Unless rates of exchange are adjusted, inflation simultaneously makes imports cheap and exports more expensive. There could also be a flight of capital induced by expectations of relative inflation rates. Third, unless price rises are predictable they introduce an element of uncertainty into economic management which may discourage investment, in particular foreign investment. Finally, inflation may, if unrestrained, end up as hyper-inflation, leading to economic and social chaos.

For these reasons, inflation cannot be allowed to get out of control. However, a distinction must also be made between short-run price increases and long-run secular price increases. Short-run price increases may be caused by temporary exogenous shocks. Trying to counteract such temporary increases may sometimes have long-term adverse effects. It is therefore necessary not only to recognise the symptom but also understand the actual causes of the malady before remedies are prescribed.

Inflation, it is well known, could be either supply induced or demand induced. Prescribing policies to curtail demand, when the problem is caused by supply bottlenecks or cost-push factors, may only lead to a situation in which there is both stagnation and inflation - the phenomenon of stagflation. This is perhaps true of the so-called Monetarist approach. The monetarist position in its simplest terms is that inflation is always a monetary phenomenon. Increases in the money supply cause demand to rise and thereby prices to move upwards. Supply elasticities in the goods and services sector are tacitly assumed to remain neutral. Hence control of inflation always and everywhere requires control of the money supply. The problem with this approach is that it ignores the fact that money supply changes could be sometimes a response to an exogeneous shock such as a rise in the price of imported oil. That is, it ignores the fact that money supply changes could be endogenous. It ignores the fact that curbing credit in such a situation could not only have little impact on inflation but could lead to an under-utilisation of productive capacity.

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2 Inability to restore real wages losses through Union bargaining may, however, lead to frustration and social unrest.

Large-scale wage increases could raise demand and cause prices to rise. The situation is similar when governments spend on large-scale infrastructure projects with long gestation periods, no matter how the expenditure is financed. Such expenditure will remain inflationary until these projects yield returns in the form of real goods and services. But can developing countries ignore the need to invest in long gestation infrastructure projects? Short-run inflation may be a price that has to be paid for development.

The supply-demand equation works nowhere so well as in the case of agricultural products, particularly food items. In view of the preponderant share of food in the consumption outlay of the great majority of the population in developing countries, food shortages -- often caused by exogenous shocks such as weather changes -- exert a great influence on the overall price level. Prices of manufactured goods and services, on the other hand, are largely determined by a mark-up on unit costs of production. This means that increases in prices in these sectors are caused by upward pressures on unit costs. Any diagnosis of inflation, and remedial measures thereof, must take into account the factors underlying such pressures.

To return to the question posed at the outset - what is the tolerable level of inflation? Any attempt at quantification is a worthless exercise. The answer lies in the trade-offs, and whether the rate of inflation would retard long-run income growth, employment and the improvement of income distribution.

4. BALANCE OF PAYMENTS

Similar questions may be raised with regard to disequilibria in the balance of payments - usually defined as a deficit or surplus in the current account. What is the tolerable limit of disequilibrium - particularly of the current account deficit?

In IMF-prompted stabilisation programmes, the adjustment path is a linear decline in the current account deficit, expressed usually as a percentage of GDP. Allowance is normally made for the absorption of grant aid but not concessionary

official credits. What really matters, however, is the basic balance, which takes into account net long-term capital flows. This is particularly important in the case of a developing country which is assured of a continuous flow of concessionary long-term credit to absorb current account deficits. Similarly, net foreign direct investment plays an important role in financing imports. Where short-term borrowings are concerned, IMF credits cannot be treated in the same way as costly commercial loans.

A balance of payments deficit reaches a critical point only when the debt service capacity has plunged to a level that threatens a particular country's credit-worthiness. When approaching this point, radical measures must be adopted to reverse the trend, reduce the imbalance, and improve the debt service capacity.

The measures available to reduce balance of payments disequilibria are well known. But whichever measures are used, they must address the basic cause of the disequilibria. Normally the primary source of imbalance is a greater rise in the value of imports as against that of exports. This may be the result of a deterioration in the terms of trade and/or of a relatively faster increase in the volume of imports compared with the volume of exports.

It was noted earlier that relative inflation, uncorrected by a change in the exchange rate, may in general cause imports to rise and exports to fall. An exchange rate devaluation is uncomplicated and has the advantage of a neutral impact on import-substitution and export development. However, it can yield the desired result in balance of payments terms only when supply and demand elasticities are sufficiently positive. Taxes and subsidies could be adopted but they are administratively difficult to target and operate. Moreover, taxes must be such that they discourage not only imports of finished goods but also their local assembly based on imported components under the cover of market protection. Turnover taxes on both inputs and import substitutes could provide these effects.

In IMF stabilisation programmes there is an implicit tendency to treat a balance of payments disequilibrium as essentially a monetary phenomenon. That is, balance of payments disequilibria are the product of disequilibrium changes in money stock. An increase in money stock leads to disequilibrium in individuals' asset portfolios.

Subsequent attempts by individuals to restore asset/price equilibria result in the expenditure of excess money balances on all other assets, including imports. This gives rise to both inflation and, in the context of a relatively fixed exchange rate, payments imbalances and a run-down of reserves. The fall in reserves leads, in the absence of further domestic credit expansion, to a contraction of the money stock and a reversal of the above process so that monetary equilibrium is restored and reserves replenished. The more flexible the exchange rate, the smaller will be balance of payments disequilibria and resulting depletion of reserves. If governments wish to avoid payments imbalances they should practise fiscal discipline and restrain excessive expansions of the money stock.[3]

The above conclusions are not only theoretically dubious, but could lead to policy prescriptions which are as erroneous as those advocated for the treatment of inflation; essentially, curbing credit when such credit is required to fuel production and economic growth.

The upshot of the brief discussion in this section is that a mechanistic treatment of balance of payments disequilibria and an incorrect wrong diagnosis of the causes of such disequilibria, could lead to policies being adopted which retard growth and impede economic development.

5. THE SRI LANKA POLICY ENVIRONMENT

In 1977 Sri Lanka made a radical break with the past in regard to economic policies. After some two decades of what may be referred to as inward-looking policies (perhaps with a small deviation from 1966-70), Sri Lanka started liberalizing the economy in 1977, orienting it towards export development and greater private sector participation, with the government basically playing a supportive role in providing infrastructure facilities.

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3 IMF Staff Members, however, would deny using this strictly "monetarist" approach - qualitative judgements are supposed to be brought into the analysis. However, it is well known that in the final setting of benchmarks for evaluation of adjustment performance, it is this accounting framework that is used.

The catalogue of policy measures adopted in the early 1980s and progressively developed since then are now well known. The thrust of these policies was the liberalization of import and exchange controls, quantitative restrictions being retained only for a small number of commodities that had to be restricted for health or security reasons. The tariff structure was simplified and the exchange rate unified and periodically devalued in an attempt to maintain purchasing power parity.

A Public Investment Programme was launched mobilising foreign aid to build infrastructure facilities in power and energy, irrigation, housing and urban development, as well as for a free trade zone. Foreign private investment was actively encouraged, mostly for export-oriented industries. A whole range of tax concessions were introduced to promote investment in the export, construction, and tourism sectors. These tax concessions have undergone several changes, but basically they have been aimed at promoting what were deemed to be socially desirable sectors.

Fiscal Policy has been determined by several objectives, which sometimes conflicted with each other. These objectives are as follows :

a. maintain an adequate flow of revenue to government without pre-empting resources to the private sector while at the same time allowing tax concessions to certain sectors;

b. keep budgetary expenditure within limits that do not prompt excessive recourse to domestic non-revenue financing, especially bank borrowings;

c. reduce recurrent expenditure by rationalising subsidies to producers and households;

d. maximise absorption of foreign aid in financing priority infrastructure projects.

Maintaining consistency of fiscal policy has been one of the major problems of Sri Lanka's development management. The structures of annual budgets have often made the achievement of this consistency an almost impossible task.

The budgetary structure has not only made it insensitive to development requirements but also vulnerable to exogenous shocks. A large proportion of revenue comes from foreign trade taxes. Taxes on exports of traditional commodities (tea, rubber and coconut) during 1981-90 yielded 8 per cent of total revenue. Even though this reflects a significant drop during the last few years, compared with an average of around 25 per cent in the early 1980s, it still poses two problems. Firstly, it poses the problem of re-investment in the traditional export sector where output has been stagnant or declining and, secondly, it makes tax revenue somewhat vulnerable both to weather patterns affecting export crops and to the instability of primary commodity prices.

Moreover, the dependence of tax revenue on import tariffs has increased over the years. From about 22 per cent of tax revenue in 1981-85, import tariffs have risen to 30 per cent during the last five years. This increased dependence is causing particular concern in view of the policy decision taken by the Government to reduce the maximum tariff rate to 50 per cent and reduce the number of tariff bands (in order to encourage industrial exports by neutralising protection to import substitutes).

A similar dilemma is faced in regard to the implementation of the Taxation Commission recommendation that corporate tax rates be reduced from a maximum of 50 per cent (plus a 10 per cent surcharge) to around 35 per cent in order to encourage tax compliance and reinvestment.

Fiscal policy in Sri Lanka has also had to cope with continuing exogenous shocks of a political nature since 1983. Defence expenditure has fluctuated between 0.5 per cent and 5.8 per cent of GDP during this period. Furthermore, political exigencies as well as natural disasters, such as floods and droughts, have made supplementary budgetary estimates a regular phenomenon.

How does fiscal policy cope with such a situation? In the case of a tightly prepared budget, where planned expenditures reflect optimum priorities, the trade-off is between, on the one hand, a marginal loss in welfare from the reduction of planned expenditures and, on the other hand, the adverse effect of an increase in the budgetary deficit. The answer certainly lies in the mode of financing the increased gap. Here too,

a decision based on mechanistic application of the GDP/financing ratio (whether through "non-expansionary" or "expansionary" financing) can be more harmful than actually retaining planned expenditures - for the reasons mentioned earlier.

Monetary policy over the years has been essentially one of tightening credit by raising the reserve ratio and/or increasing interest rates whenever money supply (M1 and/or M2) showed signs of expansion. For instance, in the Central Bank Annual Report of 1980, interest rate changes are explained as follows : "The rising inflationary pressures observed during the first quarter of the year and the declining trend in the rate of growth of savings due to negative real returns, necessitated an upward revision of short term interest rates during 1980".

This monetary policy stance has not changed since then. The 1990 Annual Report repeats: "Against a background of sustained expansion in liquidity due to domestic as well as external factors, in 1990 the authorities were obliged to continue with the restrictive monetary policy stance adopted in 1989. The need for a restrictive policy was further strengthened by continuing high inflationary pressures that existed throughout the year". The implication it appears is that the inflationary pressures were caused by an expansion of money supply. While it will be demonstrated later that this inflation was due to other factors, the question that remains to be answered here is - whether the demand for credit was a response to, or a cause of, the inflation. If it was a response, the trade-offs with growth have to be considered. Control of credit in these instances would have certainly dampened inflationary pressures, but would have simultaneously stifled growth to the extent that it restricted working capital outlays and the corresponding flow of intermediate and capital goods.

One of the significant achievements on the monetary policy front since 1986 is the introduction of a regular Treasury Bills Auction. The auction has helped reduce the share of Central Bank holdings of the stock of Treasury Bills. The Central Bank, however, continues the practice of purchasing a significant portion of each primary issue to maintain market stability and to ensure that each issue is fully subscribed. Further liberalisation may not only help reduce the extent of government borrowing which is monetized, but also to set interest rates at levels which more closely reflect the market.

6. ECONOMIC GROWTH

In the immediate post liberalization period, from 1978 to 1980, GDP grew at an annual average rate of 6.8 per cent. This rate essentially reflected the utilization of existing productive capacity made possible by import liberalisation and the accelerated flow of foreign aid. Construction (21 per cent), trade (8.7 per cent), agriculture (3.6 per cent), and manufacturing (4.4 per cent) were the major contributors. The construction sector received a tremendous boost from the Accelerated Mahaweli and Housing and Urban Development Programmes. Large budgetary deficits (23 per cent of GDP in 1980) and current account deficits in the balance of payments (20 per cent of GDP in 1980) eventually made the government prune down outlays on construction.

Large aid-flows since 1978 have contributed in considerable measure to the high growth rates experienced, especially in the initial years. GDCF (investment) was able to rise by over 20 per cent due to the increase in foreign savings - which were almost entirely composed of foreign aid.

Table I
GDP Growth and Savings

	1975-77	1978-80	1981-83	1984-86	1987-89	1990
Growth Rate*	3.6	6.8	5.3	4.8	2.2	6.2
Savings (Investment)**	15.3	27.6	29.2	24.4	22.5	22.6
National Savings	13.3	14.6	15.5	16.8	14.7	17.5
Foreign Savings	2.0	13.0	13.7	7.4	7.8	5.1

* At 1982 Constant Factor Cost Prices.
** As a percent of GDP

Agriculture, contributing over 20 per cent of GDP, still constitutes the largest sector. As a result, the overall growth rate has been very much influenced by the performance of the agricultural sector. The contribution of agriculture is felt not only directly, but also via the transport, banking, trade and other service sectors, as well as manufacturing. This is quite apparent in the low growth 1987-89 period when there was negative growth in agriculture, and in the very high growth experienced in 1990 when the agriculture sector grew by a massive 8.8 per cent. (Tables II and III).

Table II
Structure of Production
(as percent of GDP)

	1978-80	1981-83	1984-86	1987-89	1990
Agriculture	23.0	22.1	21.9	19.6	20.0
Manufacturing	14.3	14.0	15.0	16.5	17.4
Others, including construction & Services	62.7	63.9	63.1	63.9	62.6

Table III
Sectoral Growth Rates*

	1978-80	1981-83	1984-86	1987-89	1990
Agriculture	3.5	4.8	3.6	-4.8	8.8
Manufacturing	4.4	3.6	8.6	5.3	9.5

* At 1982 Constant Factor Cost Prices.

Agricultural production has been a function of external variables such as weather and international price movements, as well as internal variables such as taxes and fertilizer application. The input decisions of producers have been influenced by market prices and the availability of, and access to inputs, including credit and infrastructural and institutional support systems.

Taxes and international price movements have been the most important variables, apart from weak management of the state-owned plantations in the case of the traditional export crops tea, rubber and, to a lesser extent, coconut. Each time the international prices of these commodities went down, the authorities have had to adjust tax rates. But the broad policy of reducing tree-crop taxes still remains unresolved in view of its implications for revenue.

The manufacturing sector has shown noteworthy dynamism as reflected in Tables II and III. The performance of the manufacturing sector is much better when the processing of traditional export products (tea, rubber and coconut), whose share has diminished over the years, are excluded. A noteworthy structural change within the manufacturing sector is its increasing export orientation. However, it is just two commodities that have dominated production - petroleum products and garments.

7. INFLATION[4]

Three basic indicators are used in Sri Lanka to describe inflation. They are the Colombo Consumer's Price Index (CCPI), the Wholesale Price Index (WPI), and the implicit GDP Deflater (GDPD).

The CCPI can be described as a retail price index covering a restricted number of household consumption items. It is based on the expenditure patterns of the Colombo City dwellers, using weights compiled in 1951 according to a survey of working-class families. The WPI is closer to what may be described as a cost of production index. It is wider in coverage than the CCPI and gives greater weight to internationally traded goods. The GDPD has a still wider coverage comprising all goods and services of domestic origin weighted by their respective contributions to total value added.

The CCPI and the GDPD have been demonstrated to have moved very closely since 1978, while the WPI has moved in the same direction, though in a more volatile manner.[5] It is therefore reasonable to use the CCPI as a very good indicator of inflation in Sri Lanka.

Data for 1990 indicate that the rate of inflation was around the 20 percent mark; the CCPI registered an increase of 21.5 percent, the GDPD 19.8 percent, and the WPI 22.2 percent. This rate was roughly double that of the preceding year and represents a worrying upward shift in the level.

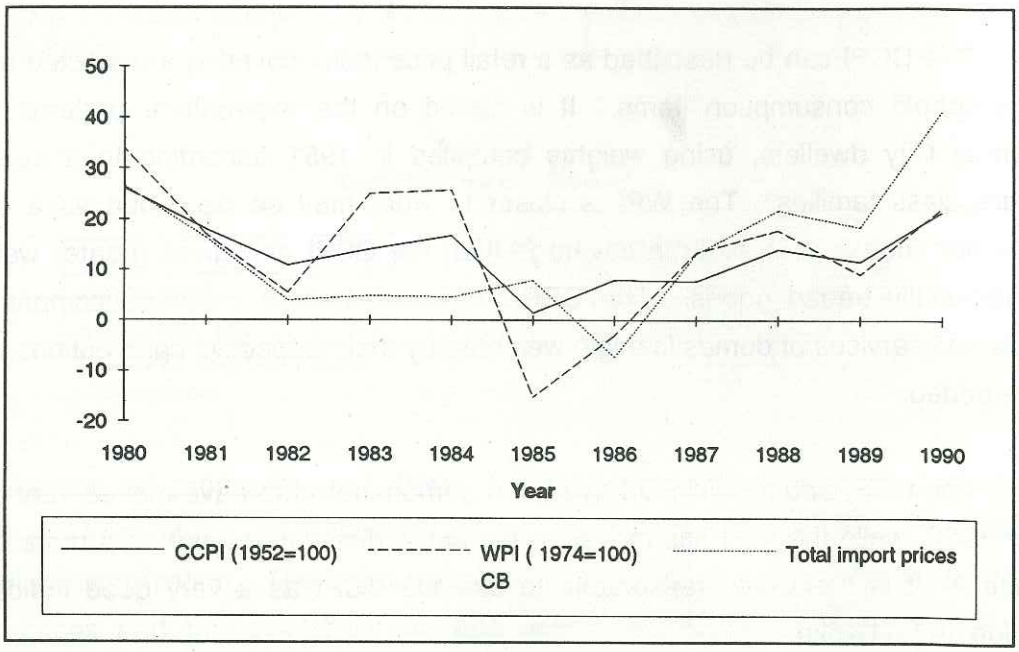
Generally, inflation is explained either by cost-push (supply driven) or demand-pull factors. On the cost-push side import prices, food prices, and administered price reforms appear to have been particularly important. Nicholas and Yatawara (1991) provide evidence to show the existence of a strong relation between import prices and the CCPI and WPI (see Figure I). Table IV indicates that there is a very close relationship between food prices and inflation. This is not surprising given the high weight of 62 per cent given to food in the CCPI. The other salient feature is the close

4 This section draws heavily from a publication of the IPS by Howard Nicholas & R.A. Yatawara (Colombo, May 1991).

5 Ibid.

movement of the group of products in the survey basket covering about 35 per cent of the items.

Figure I
CCPI, WPI vs. Import Price Index, 1980-1990



The importance of demand factors, particularly budget deficits and credit expansion, should also not be denied. Budget deficits, and more importantly, the so-called expansionary financing component (bank borrowings), can expand the reserve money base of the system, which in turn induces a corresponding expansion of money supply, thereby giving rise to inflation. But in all these cases they act more as propagators of inflationary pressures rather than as causal factors. The implication here is that control of budget deficits and credit do not in themselves help control inflation. They may have a dampening effect. On the other hand, excessive control of credit, particularly when inflationary pressures are caused by external shocks, may result in an under-utilisation of capacity by producers and low economic growth.

Table IV
Colombo Consumer Price Index

	Percentage Change						
	All Items	Food (62)	Clothing (9)	Fuel & Light (4)	Rent (0)	Miscella-neous (25)	Import Sector
1977	1.2	0.6	5.7	-2.9	0.0	2.3	-6.5
1978	12.1	16.8	1.1	1.8	0.0	7.9	24.6
1979	10.8	10.9	2.2	25.3	0.0	12.3	16.4
1980	26.1	29.0	3.8	71.7	0.0	16.4	47.2
1981	18.0	17.6	7.5	36.2	0.0	17.7	18.1
1982	10.8	12.7	6.2	6.3	0.0	9.1	9.1
1983	14.0	12.4	6.3	33.2	0.0	15.0	9.5
1984	16.6	18.1	5.6	17.9	0.0	14.6	10.4
1985	1.5	0.1	5.4	3.9	0.0	5.5.	3.2
1986	8.0	7.2	15.5	1.2	0.0	14.4	6.8
1987	7.7	8.7	7.0	0.8	0.0	8.5	3.3
1988	14.0	15.1	4.7	13.0	0.0	14.1	-
1989	11.6	10.3	16.7	12.0	0.0	15.8	-
1990	21.5	23.3	24.5	12.5	0.0	18.7	-

The 1990 experience supports the relative weight given to cost-push factors. The proximate causes of inflation in 1990 are clearly supply side; import price rises and the adjustment and liberalisation of certain key administered prices - largely in response to the increase in import prices. Table V provides data on a number of important import and administered price changes which are likely to have contributed to the escalation in inflation in 1990. Particular attention should be paid to the increases in Consumer Goods (45.5 percent), Petroleum (64.1 percent), and Fertiliser (64.8 percent) import prices, and the increase in Flour (60.3 percent), Fertiliser (132.9 percent) and GPS Paddy (34.4 per cent) administered prices. Credit, particularly to the private sector, also expanded in 1990 - by some 20 percent. But it would appear that this expansion was more a response to increases in costs rather than a source of inflationary pressures. Indeed, reinforcing the point made earlier, there are good grounds for believing that had credit not been so accommodating in 1990, the ensuing growth impetus would have been considerably stifled.

Table V
Import & Administrative Price
Inflationary Pressures

Percentage Change	1990
Import Price Index	41.4
Consumer Goods Import Price Index	45.5
Intermediate Goods Import Price Index	24.5
Petroleum	64.1
Fertilizer	64.8
Investment Goods Import Price Index	31.8
CCPI Food Index	23.3
Administered Prices (Dec. figures)	
Flour Rs./Kg.	60.3
Fertilizer Rs./MT	132.9
Paddy GPS	34.4

Source: Central Bank of Sri Lanka.

8. BALANCE OF PAYMENTS

Does Sri Lanka have a balance of payments problem? The symptoms of a problem are apparent. Sri Lanka's gross official reserves were adequate for just two months of imports at the end of 1990. The exact level of gross reserves required by a country varies with the economic situation. Sri Lanka being an import-dependent country (32 percent of GDE is imports), it is important to maintain a level of reserves that could cover lags in the flow of external payment receipts. Given the high import dependence, in normal conditions of business confidence -- that is, when the tendency for exporters to retain foreign exchange earnings abroad are minimal -- a comfortable level of gross official reserves has been considered to be in the range of three months of imports.

The other important indicator of the state of the balance of payments is the debt service capacity. It was stated earlier that what is important is not merely the current account deficit but the basic balance; that is, the ability to cover current account deficits with long-term borrowings. The critical point is reached when the debt service ratio rises to a level which threatens a country's creditworthiness. A normal rule-of-thumb threshold beyond which danger signals start emitting is the 20 per cent mark.

Sri Lanka's debt service ratio as a percentage of receipts from the export of goods and services declined from 24.6 per cent in 1989 to 16.5 per cent in 1990. This decline reflected both a reduction in debt service payments and an increase in export receipts. The debt service position in 1990 looked even better when related to foreign exchange receipts, including private transfers, which went down to 14.2 per cent as against 20.8 per cent in 1989. However, the question that arises is whether the present level could be maintained in the future.

The critical variable in this regard is the current account deficit. In order to finance large deficits it have been necessary to borrow, primarily on a long-term basis. Fortunately, borrowings has been done mostly on concessional terms, from both multilateral and bilateral donors. But these borrowings, plus short-term credits, have not been sufficient to prevent a run-down of reserves. This explains the low level of reserves at the end of 1990, though it was somewhat better than in the previous year.

So-called concessional loans (foreign aid) have also not been without some financial costs. Imports under 'foreign aid', particularly from bilateral sources have been costlier than under comparatively free exchange terms. These extra costs have also contributed to the persistent current account deficits that Sri Lanka has had to cope with in the last 14 years. (See Nicholas et al 1991 : 16)

The average annual deficit in the current account during 1978-89 amounted to 7.3 per cent of GDP, or 10.4 per cent of GDP if grants are excluded. In 1990 the corresponding figures were 3.0 per cent and 5.1 per cent, respectively. The mechandise trade account was continously in deficit over the 1978-89 period as a whole, averaging 13.5 per cent of GDP at current market prices. This deficit, however, has been coming down from 16.6 per cent for the sub-period 1978-83 to 10.4 per cent during 1984-89. In 1990, the trade deficit was 8.8 per cent of GDP.

Obviously, the deficits in the trade account are the result of import expenditure rising faster than export receipts. With the high imports/GDE ratio mentioned earlier, economic growth has to be necessarily accompanied by a growth in the volume of imports. But in Sri Lanka's case the value of such imports increased much faster due to increases in the price of imports, as shown in Figure II below. Of particular concern

was the rise in the prices of intermediate and capital goods. Expenditures under both sub-categories have increased as a percentage of total import expenditures (Table VI). The trade deficit also reflects aid absorption. The Public Investment Programme alone was financed, up to an average of 64 per cent, from aid between 1981 and 1990.

Table VI
Structure of Imports in Sri Lanka

Imports	78-80	81-83	84-86	87-89	1990
Consumer Goods	33.32	21.61	20.73	25.15	26.47
Intermediate Goods	42.72	52.83	56.99	57.79	55.45
Investment Goods	23.97	25.56	22.29	17.07	18.08
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

What has been observed in regard to the gradual reduction of trade deficits is very encouraging. However, the question is whether this trend could be continued in the future. Sri Lanka needs to accelerate her GDP growth rate in order to increase incomes and provide employment opportunities for a growing labour force and a backlog of unemployed, variously estimated as between 14.5 per cent and 18 per cent. The growth rate of GDP is closely linked to import capacity in Sri Lanka's context. If growth is to accelerate, without reducing the present import intensity of production, demand for imports should rise in real terms. Depending on future import price trends, import expenditure could rise faster. In the circumstances, an unprecedented inflow of net foreign exchange receipts from both exports of goods and services and capital flows, would be required to check a rapid deterioration in the balance of payments and an ultimate erosion of the country's creditworthiness abroad.

In the past, import expenditure rose faster than import volumes because of increases in prices (see Figure II below). There is very little Sri Lanka could do to reduce the price of imports, particularly given the inflexibility of tied aid. What can be done is to reduce import intensity of production. This applies both to production for the domestic market as well for export. Even though Sri Lanka's export structure has undergone a radical change in terms of net foreign exchange earnings, this change has been less significant.

Figure II (a)
Indices of Imported Intermediate Goods: Volume, Value & Price

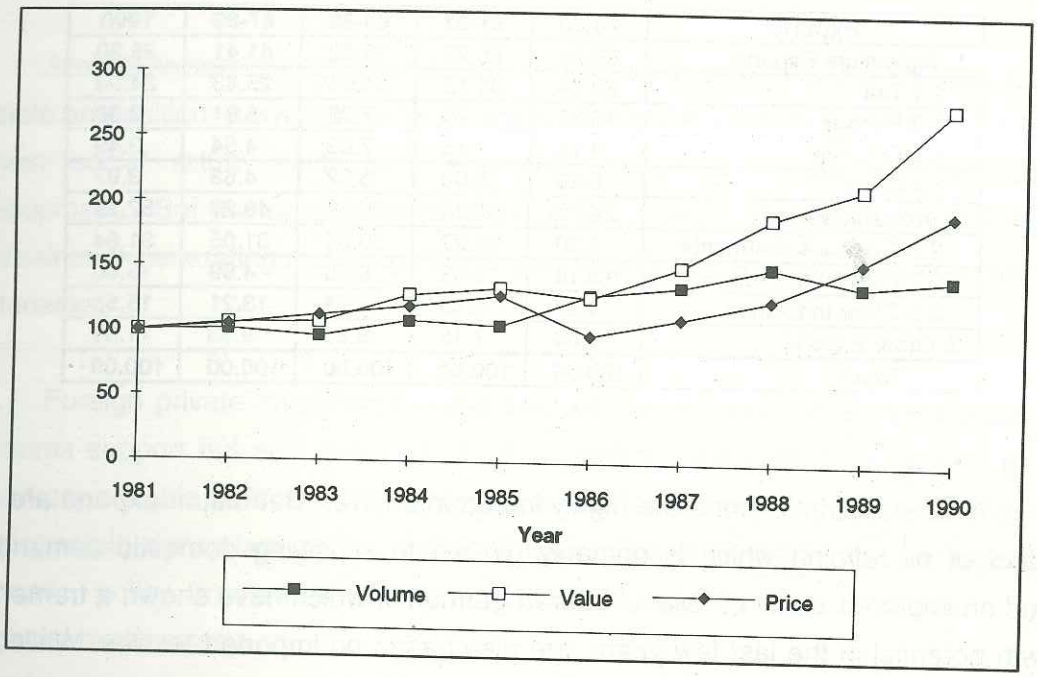


Figure II (b)
Indices of Imported Investment Goods: Volume, Value & Price

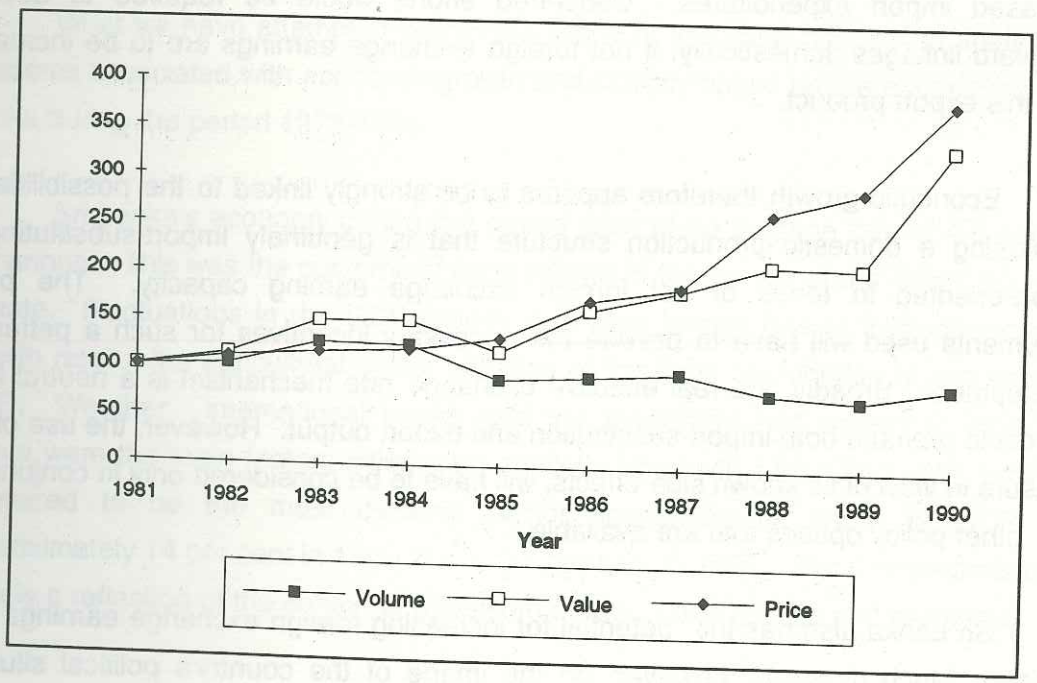


Table VII
Value of Items Exported as a % of Total Exports

Exports	78-80	81-83	84-86	87-89	1990
1. Agriculture Exports	69.74	56.75	53.82	41.41	36.30
1.1 Tea	39.74	31.12	34.94	25.43	24.93
1.2 Rubber	15.37	11.96	7.92	6.81	3.90
1.3 Coconut	9.14	7.16	7.03	4.54	3.49
1.4 Other	5.39	6.50	3.92	4.63	3.97
2. Industrial Exports	24.77	36.10	39.58	49.26	52.19
2.1 Textiles & Garments	7.30	16.57	23.05	31.05	31.64
2.2 Petroleum Products	13.19	13.93	8.95	4.99	5.00
2.3 Other Industries	4.27	5.60	7.58	13.21	15.55
3. Other Exports	5.59	7.15	6.60	9.33	11.51
Totals	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Thus industrial exports are highly import intensive. Petroleum exports are a by-product of oil refining which is primarily geared to satisfying domestic demand and based on imported crude oil. Manufactured garments, which have shown a tremendous growth potential in the last few years, are also based on imported textiles. While there are difficulties in expanding the export of quota-limited garments, which constitute the bulk of these exports, the increase in the export of garments will have to be sufficiently high to generate a significant portion of the net foreign exchange required to finance increased import expenditures. Concerted efforts would be required to develop backward linkages domestically, if net foreign exchange earnings are to be increased from this export product.

Economic growth therefore appears to be strongly linked to the possibilities of developing a domestic production structure that is genuinely import-substituting or export-oriented in terms of net foreign exchange earning capacity. The policy instruments used will have to provide the necessary incentives for such a pattern of development. Broadly, the real effective exchange rate mechanism is a neutral force that could promote both import-substitution and export output. However, the use of this measure in view of its known side-effects, will have to be considered only in conjunction with other policy options that are available.

Sri Lanka also has the potential for increasing foreign exchange earnings from tourism. Much depends, however, on the image of the country's political situation

abroad. The advantage of tourism -- it has its social costs too -- is its linkage effects. These could generate a large range of opportunities for employment creation.

Mobilising foreign aid for accelerating economic growth is still an economically feasible proposition, provided the terms are right and such aid is channelled to areas of highest social return such as economic infrastructure and human resource development. But the absorptive capacity of aid is limited by the present budgetary constraints of generating matching counterpart local funds, as well as by administrative bottlenecks.

Foreign private investment in this context can not only be a direct balance of payments support but also a generator of technology and markets for export growth. Apart from a stable political climate, foreign private investment flows are dependent on the economic dynamism of the recipient country, and in particular on the macro-economic policy framework, human resources, economic infrastructure, and a congenial bureaucracy.

9. CONCLUSIONS

What we have attempted within the scope of this short paper is to analyse the problems associated with economic growth and stability based on the experience of Sri Lanka during the period 1978-1990.

Sri Lanka's economy during this period grew at an average rate of 4.8 per cent per annum. This was the outcome of large inflows of foreign aid and a liberal economic climate. Fluctuations in the GDP growth rate were largely due to fluctuations in the growth rate of the agricultural sector because of the large contribution of this sector to GDP. Weather, international prices, and the availability and access to production inputs were the main factors influencing agricultural growth. Manufacturing, however, appeared to be the most dynamic sector, increasing its share of GDP from approximately 14 per cent in 1980 to over 17 per cent in 1990. But this dynamism was largely a reflection of the growth of petroleum products and textiles and garments.

The growth process during the 1978-90 period was accompanied by high rates of inflation, except during a few years when these rates dropped to single digit figures. The major cause of inflation appeared to be cost-push factors, mostly induced by higher import prices. Domestic supply shortages too may have played a significant role in certain years. Of particular importance in this regard is food, which constitutes the largest item in the basket of goods used for the calculation of the cost of living index. Fiscal and monetary factors may have propagated inflationary tendencies but could not have been the primary cause in most years. However, each time the inflation rate has caused concern, the authorities were constrained to apply fiscal and monetary controls. A quantitative assessment of the effect of these measures either on the inflation rate or the growth rate of GDP was not attempted in this paper.

The large dependence of the economy on imports and the heavy recourse to foreign concessionary financing of investment are quite naturally reflected in the balance of payments. Sri Lanka has continuously run current account deficits since 1978. These deficits were also influenced by higher import prices and the inability to generate compensatory net foreign exchange earnings from either import-substitutes or exports. In the context of an inadequacy of capital flows these deficits have led to a progressive contraction of official reserves to levels which, by the end of 1990, were barely adequate to meet two months of import requirements. However, the debt service ratio as a percentage of export of goods and services, has recently improved, declining to 16.5 per cent in 1990.

The question that may be posed at this juncture of Sri Lanka's economic development is, if an attempt were made to push for a higher rate of growth of GDP, what would be the implications for inflation and the balance of payments? This question is particularly relevant if Sri Lanka's GDP growth is to be pushed to an average of 8.3 per cent per annum -- the rate that is required to double its per capita income of $ 418 and reduce unemployment from 18 to 5 or 6 per cent by the year 2000. Will such a high growth rate fuel inflationary pressures and cause further deterioration in the balance of payments? Most important, given the symbiotic relationship with growth, will inflationary pressures and balance of payment deficits ultimately stifle growth itself? The outcome will depend on how growth is to be fostered.

Inflation and balance of payments problems which are due to exogeneous factors such as international price increase and supply shortages (caused by climatic factors), cannot be either avoided or effectively controlled. Demand -- restrictive measures through fiscal and monetary policy could contain the propagation of internal and external instability. But beyond a certain point, such restrictive measures could adversely affect growth and even aggravate cost-push inflation. If these pressures are short-run, the best policy would be to allow the market to restore equilibrium; if they are long-term, in the sense that they represent equilibrium changes in relative prices, the problem is clearly structural and the solution requires policies which would bring about the required structural changes.